

MSP STEEL & POWER LIMITED



EMPOWERING STEEL BUSINESS

- Pellets a -strategic advantage in a scenario of rising iron ore prices.
- Better integration engendering increase margins.
- Merchant Power -an Added advantage.
- Captive Iron ore blocks and coal blocks to increase its strengths further.
- Further expansion plan to increase its top line.



MSP STEEL & POWER LIMITED

BUY

Empowering Steel Business

We initiate coverage on MSP Steel & Power Limited (MSP Steel) with a BUY rating. MSPL is integrating backward rapidly, which will bring about cost savings and improve margins. It has undertaken massive capex of Rs8.14bn to increase production capacity of sponge iron and pellets. A strong track record would help MSP Steel to ride on upbeat demand for steel in India. MSP Steel trades at P/E of 7.22, which is moderately inexpensive compared with its peers. We believe the stock will re-rate when the market starts taking cognizance of these positives. At our target price of 90, MSP steel offers 30% potential upside from the current level.

Domestic demand underpins India's steel story

World Steel Association (WSA) expects steel demand in India to grow 13.9% and 13.7% in 2010 and 2011 respectively to 71.6 mt. We conservatively estimate demand to grow 8-8.5%. Investments in infrastructure and construction and an upturn in the automobile and consumer durable sectors will power this growth. The growing demand has pushed up steel prices and it augurs well for MSP Steel.

Capacity expansion to assist top-line growth

MSP Steel is spending Rs8.14 bn to increase production capacity for sponge iron and pellets and power. This would support increased sales volumes and revenue growth.

Better integration engendering increase margins

MSP Steel is vigorously focusing on achieving better integration. This would provide it the resilience to face pricing pressures and would make it less vulnerable to cyclicality. MSP Steel benefits from low-cost production vis-à-vis non-integrated peers. Further, increase in captive power capacity to 76 MW would support margin expansion. In addition, when it commissions iron ore mining capacity in FY13-14, the company would emerge as a fully integrated player.

Pellets a strategic advantage in a scenario of rising iron ore prices

Iron ore pellets are gaining importance in a scenario of rising iron ore prices. Thus, MSP Steel's strong focus on pellets would be a strategic advantage in the current scenario. MSP Steel is expanding pellet capacity by 0.6 mn tonnes by FY12, which would take total pellet capacity to 0.9 mn tonnes. Moreover, it has a beneficiation plant that enables it to produce sponge iron using cheaper iron ore fines with lower FE content. This would enhance profitability margins further.

Valuation:

We value MSP Steel's steel business on EV/EBIDTA at 5x FY12E and the power business using DCF valuation at Rs 11.44. At CMP of Rs 70, the stock trades at 7.2x FY11E EBIDTA. Our SOTP valuation yields target price Rs 90 (consolidated).

Financial Snapshot

Rs Mn	FY08	FY09	FY10	FY11E	FY12E
NET REVENUES	3607	3989	3887	6161	8752
OPERATING PROFIT	671	610	641	1263	2075
OPERATING PROFIT MARGIN	19%	15%	16%	20%	24%
PAT	467	399	321	583	951
NET PROFIT MARGIN (%)	13%	10%	8%	9%	11%
PE (X)	5.29	2.48	7	7.22	4.43
P/BV (X)	3.13	2.40	1.82	1.57	1.15
ROCE (%)	24%	17%	10%	18%	17%
EV/EBIDTA	5.26	4.64	9.1	7.2	5

Target Price	90
CMP (19 Oct)	70

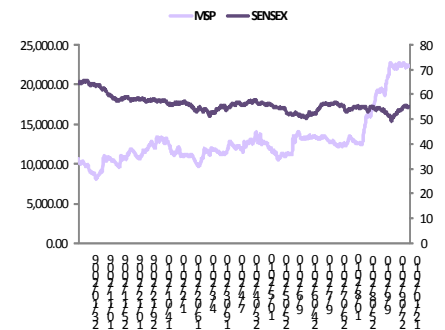
Key stock data

BSE Code	532650
NSE Code	MSPL
Bloomberg	MSPIN
Shares O/S (mn)	58
Market cap (Rs Mn.)	4220
52-wk high/low	74/25.30

Shareholding pattern	(%)
Promoters	71.80
FII's	-
Banks & DI	-
Public	28.20

Source: Company

Stock Performance



Source: Bloomberg, Focus Research

Jinesh Lodaya

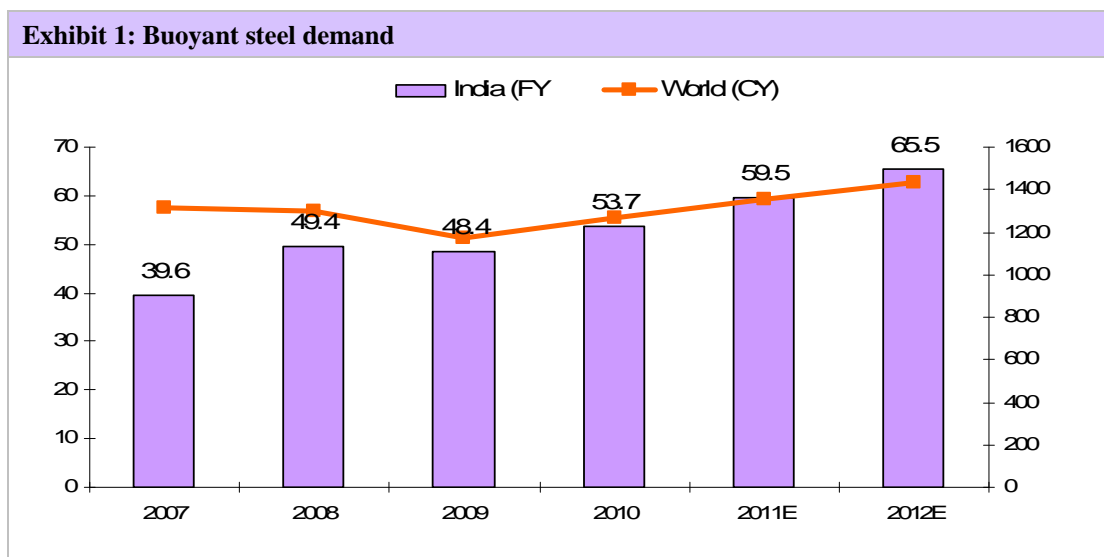
jinesh.lodaya@focuscomtrade.com

Tel: +91-22-67473702

INVESTMENT RATIONALE

Domestic demand underpins India's steel story

World Steel Association (WSA) expects steel demand in India to grow at 13.9% and 13.7% in 2010 and 2011 respectively to 71.6 mn tonnes. We conservatively, estimate demand to grow 8-8.5%. Investments in infrastructure and construction and an upturn in the automobile and consumer durable sectors will power this growth. Government of India's (GoI's) fiscal stimulus and monetary easing initiatives of the central bank to lend support to the economy in a state of recession have been crucial in catalyzing this growth. Moreover, global steel demand too is expected to increase at 7-9% during CY10 and CY11, which compares favorably with Indian trends. The growing global demand has pushed up steel prices and it augurs well for MSP Steel.



Source: Focus Research, CRISIL

The recovery in the global economy has supported steel demand. Globally, Steel prices have increased from \$540 per tonne in CY09 to \$650-685 per tonne in CY10. While, domestic prices have increased in tandem and prices of TMT are hovering around Rs 28500 per tonne. We believe the strong demand environment, backed by robust demand from the infrastructure and the automobile sectors, would allow steel companies to pass on the increases in input costs.

Capacity expansion to fortify backward integration and support top-line growth

MSP STEEL has undertaken a massive expansion plan of Rs8.14bn over FY10-FY12 to strengthen its backward integration by increasing capacities of pellet, sponge iron, and power, along with increasing its coal washer to support the increased usage of coal. The company is also extending its railway sidings from 2.4Km to 6.4Km in preparation of handling more material in future. This would help to reduce its transportation cost of raw materials and ease handling constraints. MSP Steel's further move into backward integration include acquiring iron ore mines with reserves of 35 mn tonnes which is likely to get commissioned by FY13-14, including coal block of 175 mn tonnes which includes company's share of 26 mn tonnes

Better integration engendering increase margins

MSP Steel is vigorously focusing on achieving better integration. This would provide it the resilience to face pricing pressures and would make it less vulnerable to cyclicity. MSP Steel benefits from low-cost production vis-à-vis non-integrated peers. Further, increase in captive power capacity to 76 MW would support its margin expansion. In addition, when it commissions iron ore mining capacity in FY13-14, the company would emerge as a fully integrated player. MSP Steel has installed capacity of 24 MW of power as against a requirement of 19-20 MW for captive use. With ongoing expansion, the installed capacity will increase to 76 MW by FY12. Thus, the company would be able to sell around 34 MW power on merchant basis. **For our valuation purpose, we have assumed Net Realization of Rs 3.5 per unit of power, while the variable cost is Rs 0.8 per unit and fixed cost at Rupee 1 per unit of power.**

Exhibit 4: Expansion of power

Power (MW)	EXISTING	ADDITIONS		TOTAL
		FY10-11	FY11-12	
AFBC	8	10	26	44
WHRB	16	8	8	32
TOTAL	24	18	34	76

Pellets a strategic advantage in a scenario of rising iron ore prices

Iron ore pellets are gaining importance in a scenario of rising iron ore prices. MSP Steel's strong focus on pellets thus would be a strategic advantage in the current scenario. MSP Steel is expanding pellet capacity by 0.6 mn tonnes by FY12, which would take total pellet capacity to 0.9 mn tonnes. Moreover, it has a beneficiation plant that enables it to produce sponge iron using cheaper iron ore fines with lower FE content. This would enhance profitability margins further.

Currently, MSP Steel is buying iron ore fines having 58-60 FE content at landed cost of Rs1500/MT instead of lumps which cost Rs6000/MT. The company processes fines at Rs2500/MT, which helps save costs to the tune of Rs2100. MSP Steel has a long-term understanding with Essel Mining, Runгла Mining and Patnaik Mining for supply of iron fines and has linkages for iron ore with NMDC/OMDC.

COMPANY BACKGROUND

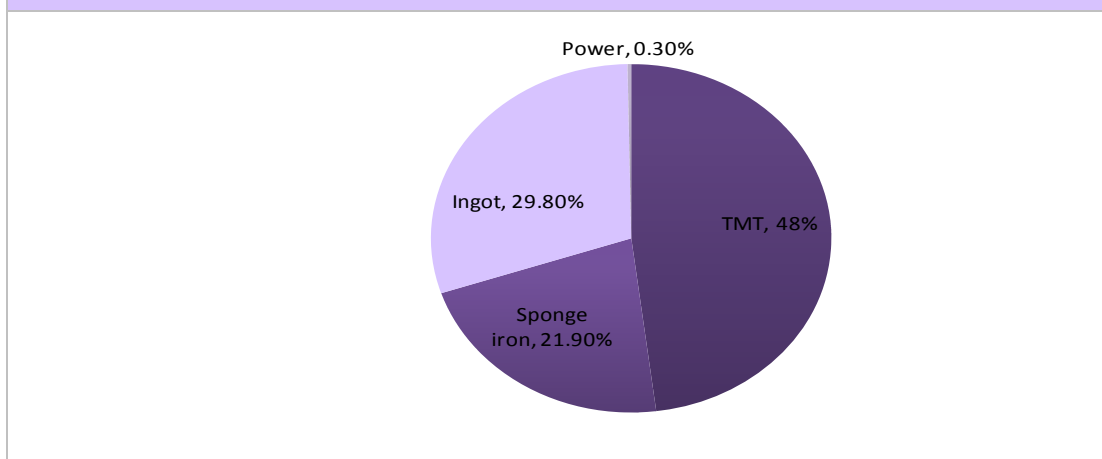
Incorporated in 1968 as Adhunik Rollers Pvt Ltd, the company changed to MSP Steel and Power Ltd. (MSP Steel) in March 2003. Company is integrated steel manufacturer in eastern belt of India, while it produces Sponge iron, Billets, TMT, Structural steel, Angles, Channel, Plate and Beams. MSP Steel has also captive power plant, while its manufacturing facilities are located at West Bengal, Orissa, Jharkhand, Andhra Pradesh, Chhattisgarh and Maharashtra.

Exhibit 5: Product Portfolio

MT	Existing capacities	Production		Capacity utilization	
		2009	2010	2009	2010
Sponge iron	192,000	124,896	155,851	65%	81%
Mild steel Billets	144,100	95,078	107,579	66%	75%
Construction bars(TMT)	80,000	56,506	68,385	71%	85%
Power(KWH)	190,080,000	137,088,268	161,783,321	72%	85%

Source: Company data, Focus Research

Exhibit 6: Revenue Break up of FY10:



Source: Company data, Focus Research

MSP Steel is likely to increase its sponge iron capacity to 423000 mn tonnes from the current scenario of 192000 mn tonnes by FY12, for which the company is likely to infuse around Rs 2.33 Bn. With this expansion the company would face volatility in sponge iron price at the present level of forward integration, as company cannot absorb the entire production of sponge iron.

For FY11-FY12 the company has the capex plan of Rs 8.14 Bn, which includes debt of Rs 5.45 Bn. It has already spent Rs 3 Bn as on 31st August 2010.

Exhibit 2: Expansion plan

Particulars	Current	Phase I	Phase II	Total
Sponge iron	192000	115500	115500	423000
Pellet	300000		600000	900000
Billet	144109			144109
Coal washery	345600		383525	729125
Thermal power plant (MW)	24	18	34	76
Structural	128000			128000
Railway sidings	2.4		4	6.4km
Completion date		Oct-2010	Jul-2011	

Source: Company data, Focus Research

Exhibit 3: MSP Steel's further moves into backward integration include:

Nature of mines	Location of mines	Mining area	Reserve	Commission
Coal Block	Chhattisgarh	713.952 hectares (14.89% allotted in the consortium)	175 mn tonnes (MSP STEEL shares 26 mn tonnes)	Last quarter of FY11, pending forest clearance rest of clearance approved.
Iron Ore Block	Durkandol, Forest range Dist Kanker Chhattisgarh	150 Hectares	35 Mn tonnes	FY13-FY14.

Source: Company data, Focus Research

Of its total coal requirement, MSP Steel has linkages for 2, 75,000 with Coal India Limited. It purchases the balance through E auctions. Currently, the company is sourcing coal at Rs 1300/MT. It has been allotted a coal mine which would help to reduce costs to Rs 750/MT, helping save Rs 650/MT.

Currently, MSP Steel is buying iron ore fines having 58-60 FE content at landed cost of Rs1500/MT instead of lumps which cost Rs6000/MT. The company processes fines at Rs2500/MT, which helps save costs to the tune of Rs2100. MSP Steel has a long-term understanding with Essel Mining, Rungla Mining and Patnaik Mining for supply of iron fines and has linkages for iron ore with NMDC/OMDC.

Exhibit 7: Peer Comparison:

Companies	P/E		EV/EBIDTA		OPM		PAT Margin		ROE		ROCE	
	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
SAIL	13.5	9.27	7.98	6	25%	26%	17%	17%	18%	20%	13.20%	13%
Tata Steel	7	5	4.95	4.67	14.50%	16%	6%	7%	25%	22%	13%	15.40%
JSW Steel	17.5	7.8	5.6	5	20.30%	28.40%	6.30%	13.40%	22%	29%	12.30%	19.30%
Monnet ISPAT	1.6	8.8	10.1	8.4	27.30%	28.40%	16%	14.90%	14.2	15.40%	10.40%	11.80%
Tata Sponge iron ltd	5.6	5.2	2.5	2	24.2	25.1	16%	17%	21.10%	19%	28.70%	26.20%
MSPL	7.22	4.43	7.2	5	20%	24%	9%	11%	22%	27%	18%	17%

Source: Bloomberg, Focus research.

Exhibit 8: Comparative steel matrix

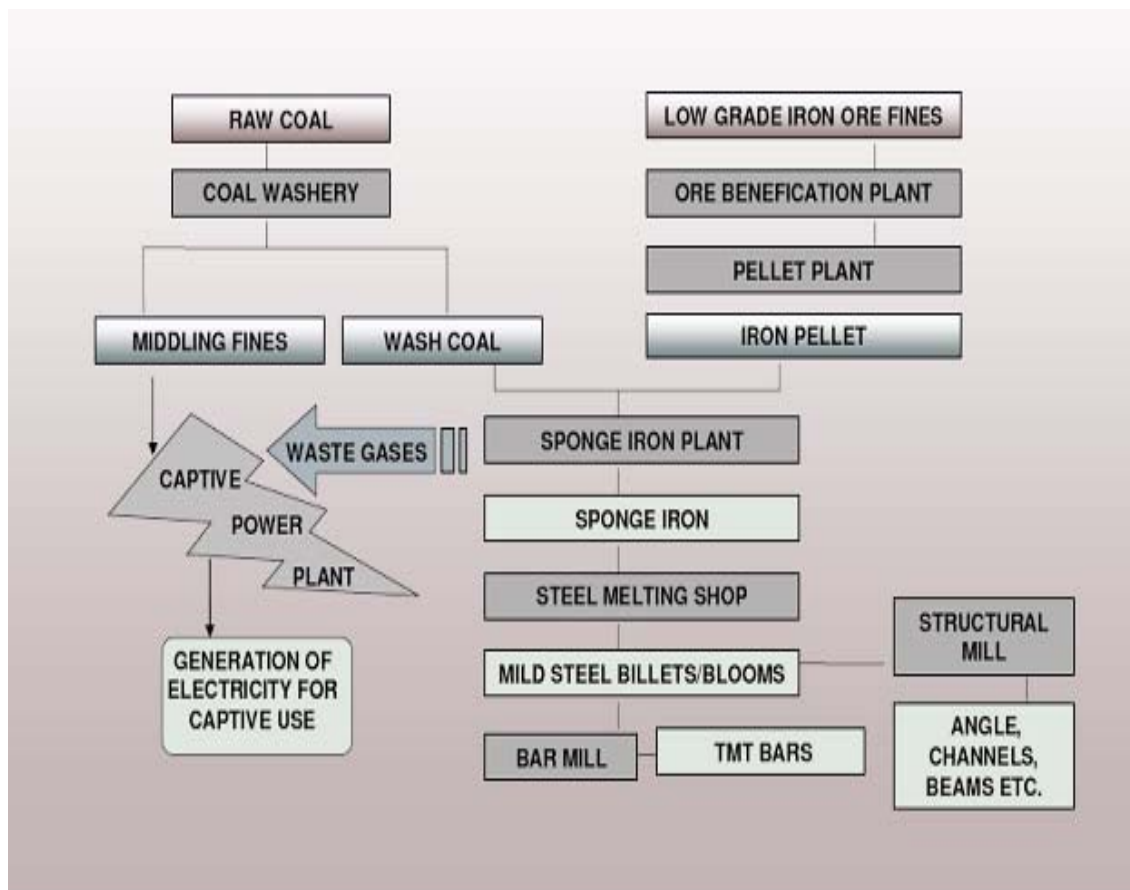
Points	Main Players	Secondary players	Non-integrated players
Companies	Tata Steel, JSW Steel, SAIL	MSPSPL, Essar Steel, Llyod steel, Adhunik Metaliks,	Modern
Steel Making process	Blast Furnace/ Blast Oxygen Furnace	Electric Arc furnace	Induction furnace
Raw materials	Iron ore and coal	Iron ore and coal	Sponge iron and scrap
Iron ore Mines	Fully Captive or Partially Captive	Few Partially captive	x
Coking coal	Partially Captive	Imports or linkages with coal India	Imports
Product quality	High	medium	low- high
Brand value	Have good brand value	Few have brand value	x

Source: Bloomberg, Focus research.

INDUSTRY ANALYSIS

Sponge iron is substitute of scrap and used to making steel through secondary route EAF/IF. Sponge iron is produce through 2 routes- coal based and gas based. In coal based, it is produced in the form of lumps. In the gas based, it is produced in the form of briquettes.

India is largest sponge iron producer in the world. The country's share in global market of sponge iron was 40% in 2009. India produces around 21 mn tonnes of sponge iron in 2009. The growth of sponge iron was mainly due to healthy growth in steel production and the substitution of scrap.



VALUATION:

We initiate coverage on MSP Steel with **BUY** recommendation. We value MSP Steel using SOTP valuations due to different dynamics of its business. Its steel business is valued at 5x FY12E EBITDA at Rs 78.55 while its power business is valued using DCF approach, with Net Present Value (NPV) of Rs 664 Mn (NPV at Rs 11.44 per share) after assuming cost of equity at 13% and cost of debt at 11%. At CMP of Rs 71.80, the stock is trading at 7.2x FY11E EBITDA. Our SOTP valuation yields target price Rs 89.98 (consolidated) with upside of 29% from current levels.

Exhibit 9: Key assumptions and Valuation

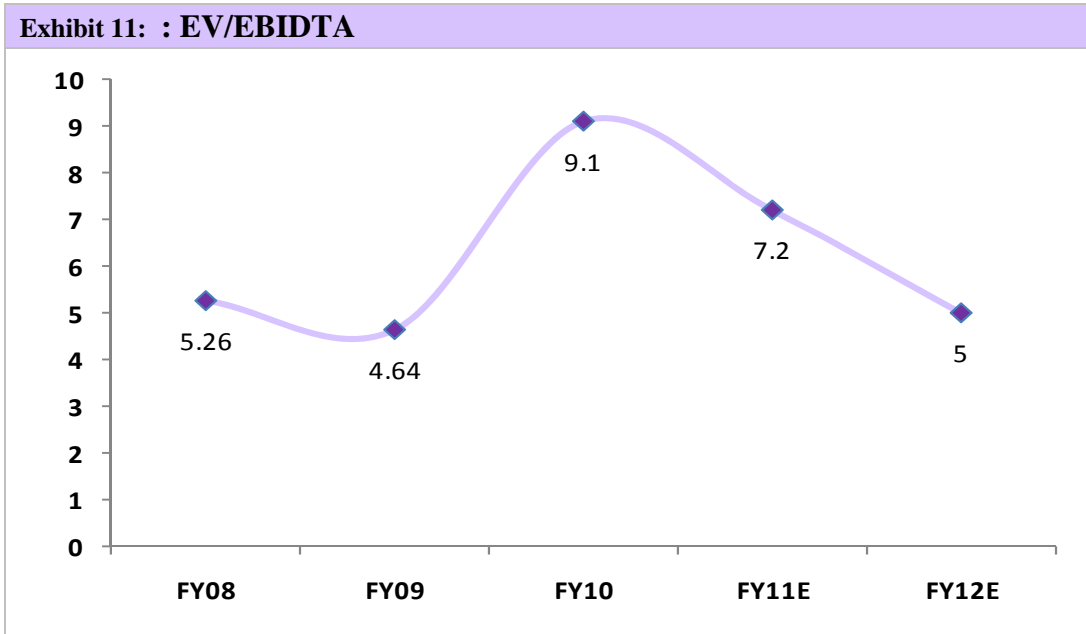
Key Assumptions	Structural		TMT	
Sales volume tonnes	108800	108800	68000	68000
Average realization per tonne	30800	32340	26000	28500
YoY Growth		5%		10%
Operating expense per tonne	23577	24818	23559	24577
YoY Growth		5%		4%
EBIDTA per tonne	7223	7522	2441	3923

Exhibit 10: Fair value

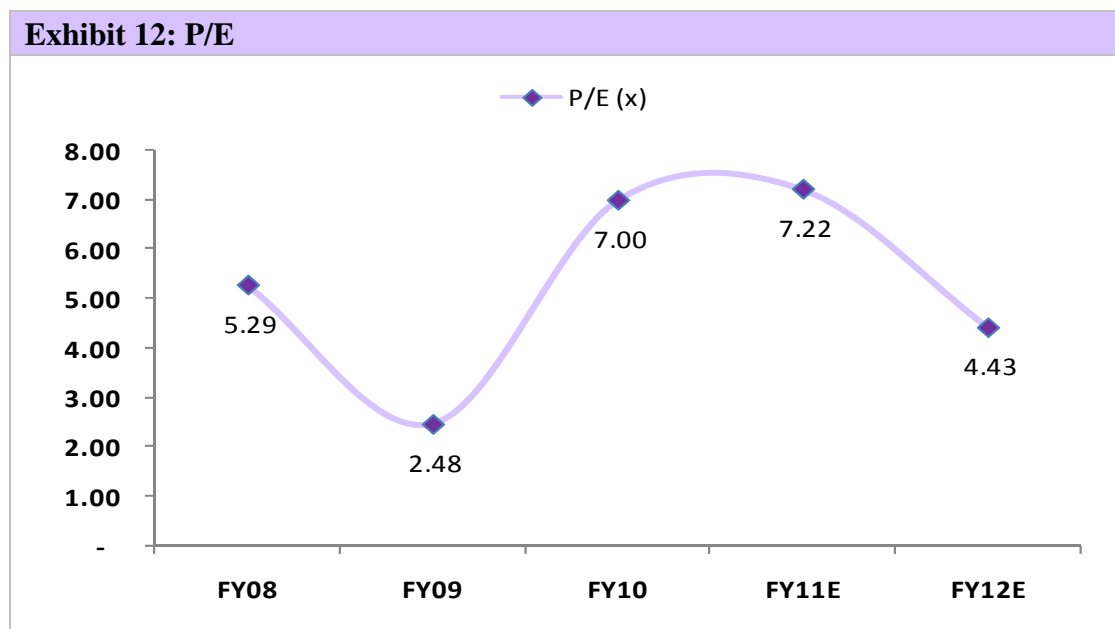
Contents	FY12E
Steel business EBITDA (Rs in mn)	2146
EV/EBIDTA (X)	5
EV (Rs in mn)	10732
Less debt (Rs in mn)	9061
Cash balance(Rs in mn)	207
Investment (Rs in mn)	450
CWIP (Rs in mn)	2237
Market cap (Rs in mn)	4564
No. of shares (mn)	58
Steel business NAV	78.54
Power business NAV	11.44
Fair value per share (consolidated basis)	89.98
CMP	70
Upside	29%

Investment concern:

- Any delay in capacity expansion would affect our estimates.
- Higher than expected cost of raw material such as iron ore and coal may impact MSP Steel's earnings due to low level of backward integration.
- Lower than expected recovery in the Indian markets may put pressure on demand drivers and consequently impact steel demand prices.



Source: Company data, Focus Research



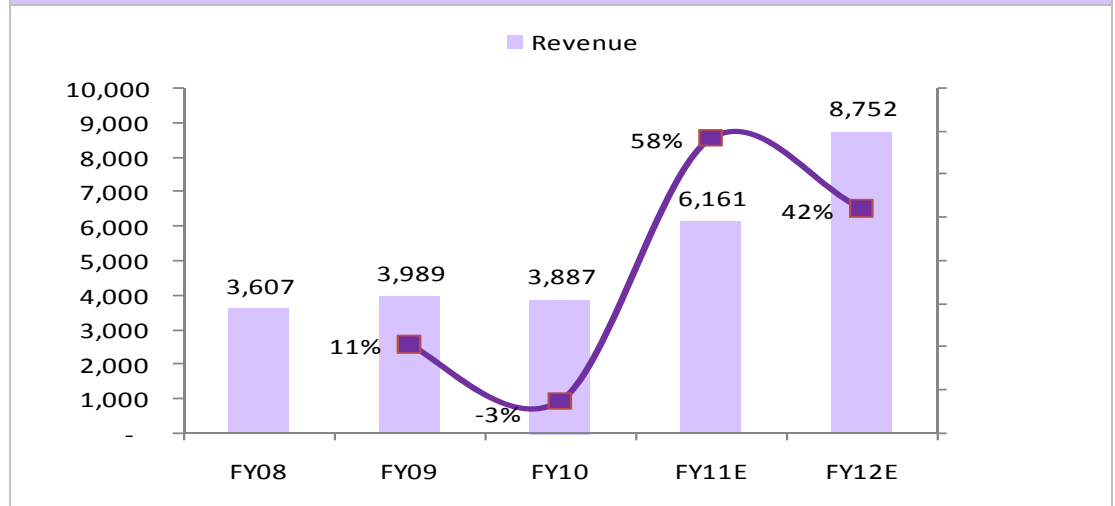
Source: Company data, Focus Research

FINANCIAL ANALYSIS

Strong top-line growth on higher volume and prices

We expect MSP steel's Net Revenues would be boosted by strong volume growth and better prices, due to capacity expansion and internal cost savings initiatives. We expect net revenues to be Rs 6161 Mn in FY11E and Rs 8752 Mn in FY12E from Rs 3887 Mn in FY10 with the negative growth of 3% to 42% growth in FY12E

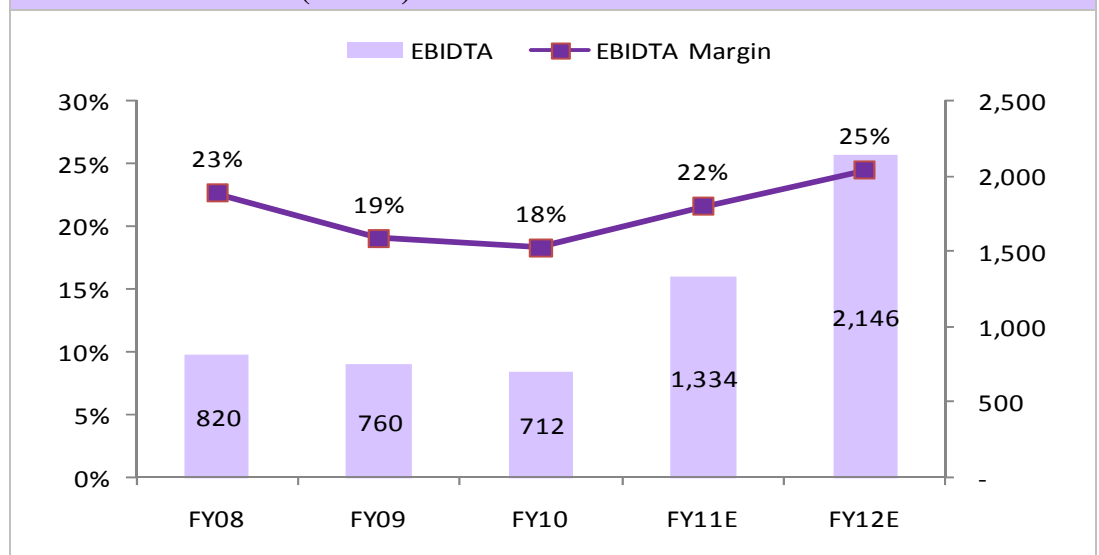
Exhibit 13 : Net Revenue (Rs Mn)



Source: Company, Focus Research

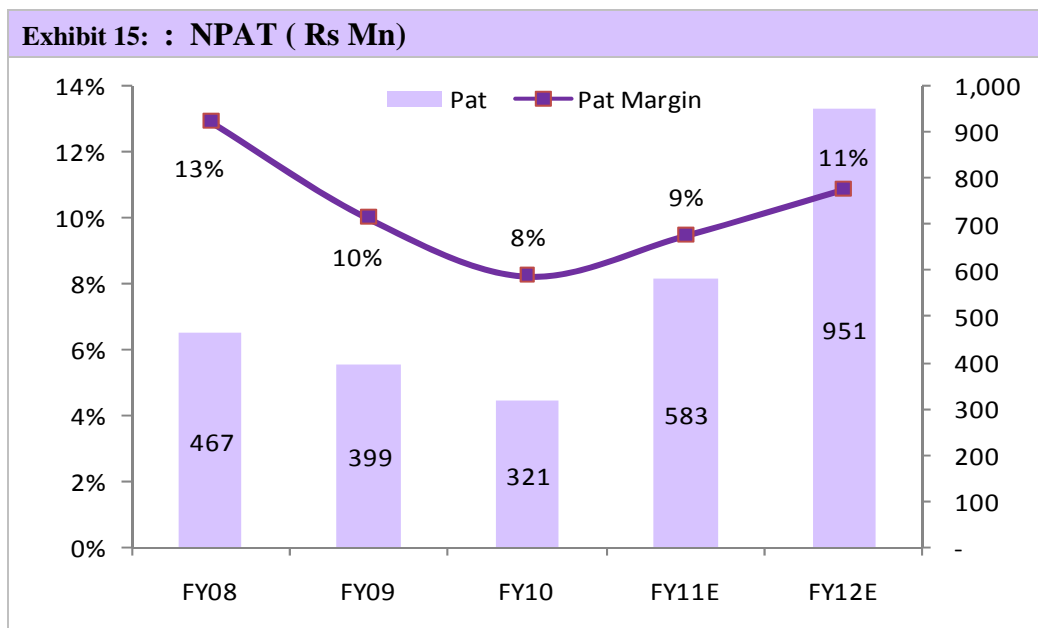
The company's EBIDTA increased from Rs 712 Mn in FY 10 to Rs 2146 Mn in FY12E due to better product mix and improvement in EBIDTA margin from current level of 18% to 25% in FY12E.

Exhibit 14 : EBIDTA (Rs Mn)

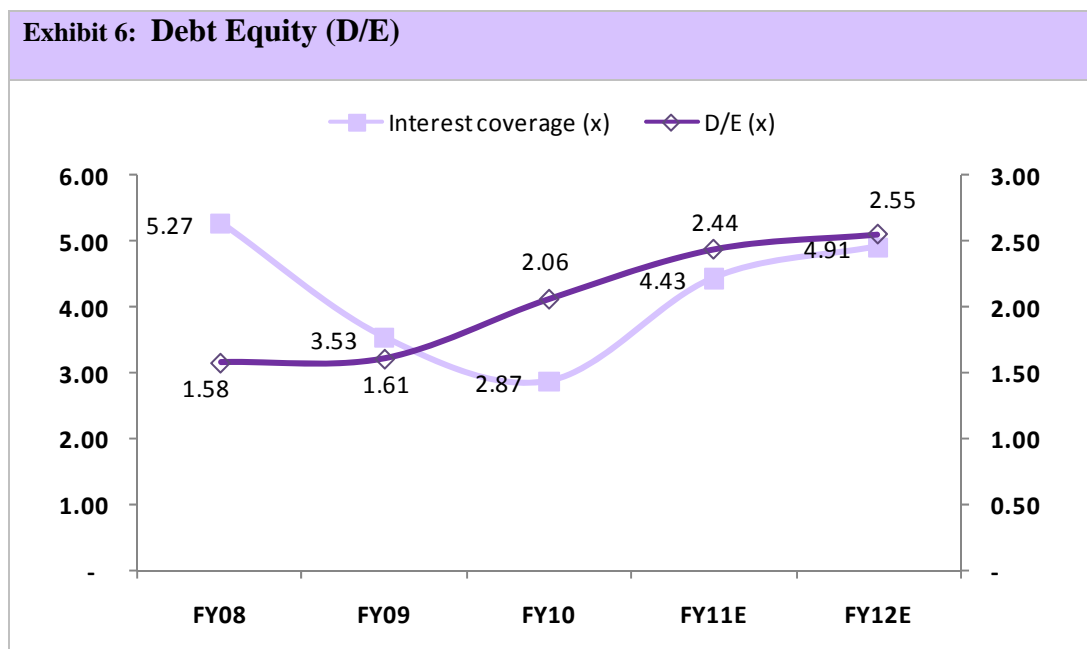


Source: Company, Focus Research

However, due to company’s cost cutting initiatives and decline in raw material cost, we expect NPAT to grow faster than revenue. We expect NPAT to rise from Rs 3201 Mn in FY10 to RS 951 Mn in FY12E i.e. 72% CAGR FY10- FY12 and there will be considerable rise in PAT margin from 8% in FY10 to 11% FY12E.



Source: Company, Focus Research



Source: Company, Focus Research

Interest coverage ratio has increased to 4.91 times, while Debt Equity ratio has increased from 2.06 in FY 10 to 2.55 in FY12 E. The improvement of interest coverage ratio is due to rise in the EBIT margins from 15% in FY10 to 20% in FY12E.

FINANCIALS

(Rs Mn)

Income statement	FY08	FY09	FY10	FY11E	FY12E
Sales	3,607	3,989	3,887	6,161	8,752
Expenditure	2,937	3,379	3,246	4,898	6,677
Operating profit	671	610	641	1,263	2,075
Other income	149	150	71	71	71
EBIDTA	820	760	712	1,334	2,146
Interest	142	194	204	253	362
Depreciation	73	74	126	210	365
PBT	605	492	382	870	1,419
Tax	138	93	62	287	468
PAT	467	399	321	583	951

Source: Focus Research estimates

(Rs Mn)

Balance Sheet	FY08	FY09	FY10	FY11E	FY12E
Sources of funds					
Equity share capital	581	581	581	581	581
Share application money			222		
Reserve and surplus	718	1,111	1,432	2,015	2,966
Net worth	1299	1692	2235	2596	3547
Loans funds	2,053	2,727	4,611	6,336	9,061
Deferred tax liability	92.5	158.3	198.6	198.6	198.6
Capital employed	3,444	4,578	7,044	9,130	12,806
Applications of funds					
Total fixed assets	2,183	3,325	5,013	8,552	10,424
Investment	61	67	450	450	450
Working capital	1,195	1,185	1,582	129	1,933
Misc exp	5				
Capital employed	3,444	4,578	7,044	9,130	12,806

Source: Focus Research estimates

(Rs Mn)

Cash Flow Statement	FY11E	FY12E
Net cash flow from operating activities	1,205	855
Net cash flow from investing activities	(3,678)	(2,166)
Net cash flow from financing activities	1,250	2,363
Net increase/decrease in cash	(1,224)	1,052
Opening bal of cash	379	(845)
Closing bal of cash	(845)	207

Source: Focus Research estimates

Ratio	FY08	FY09	FY10	FY11E	FY12E
Interest coverage (x)	5.27	3.53	2.87	4.43	4.91
D/E (x)	1.58	1.61	2.06	2.44	2.55
P/E (x)	5.29	2.48	7.00	7.22	4.43
P/BV (x)	3.13	2.40	1.82	1.57	1.15
EV /EBIDTA (x)	5.26	4.64	9.1	7.2	5
Current ratio (x)	2.93	5.82	3.29	1.11	2.30
Asset turnover (x)	0.90	0.84	0.53	0.62	0.63
Fixed asset turnover (x)	1.65	1.20	0.78	0.72	0.84
OPM (%)	19%	15%	16%	20%	24%
EBIDTA Margin (%)	23%	19%	18%	22%	25%
PAT (%)	13%	10%	8%	9%	11%
ROE (%)	36%	24%	14%	22%	27%
ROCE (%)	24%	17%	10%	18%	17%
EPS	8.03	6.87	5.52	10.04	16.36
BVPS	22.35	29.13	38.47	44.68	61.04

Source: Focus Research estimates

INSTITUTIONAL SALES

Sanjay Dhelia (Head Institution)	sdhelia@focuscomtrade.com	022-67474317
Vishal Luhadia (Sales Manager)	vishal@focuscomtrade.com	022-67474706

FUNDAMENTAL RESEARCH

Jinesh Lodaya (Metal Sector)	jinesh@focuscomtrade.com	022-67473702
Hardik Shah (Cement Sector)	hardik@focuscomtrade.com	022-67473702
Saurabh Gupta (Power Sector)	saurabh.gupta@focuscomtrade.com	022-67473702

ALTERNATIVE RESEARCH

Rahul Bhandawat (Technical)	rahul@focuscomtrade.com	022-67474310
Sunil Rokade (Technical)	sunil@focuscomtrade.com	022-67474310
Dipansavla (Derivatives)	dipansavla@focuscomtrade.com	022-67474708
Amit Singh (Astrology)	astrology@focuscomtrade.com	022-67474708

DEALING & OPERATIONS

Kejas Shah (Head Dealing)	kejas@focuscomtrade.com	022-67474318
Ketan Mange (Head Operations)	ketanm@focuscomtrade.com	022-67474703

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Focus Shares & Securities Pvt. Ltd

East Wing, Third Floor, Forbes Building, Charanjit Rai Marg, Fort Mumbai 400 001